

A Formula for Sustainability in a Regulated World

Forum

Date: 16 October 2008

Hosts

Accenture

Chair

Charlie Wagstaff, Criticaleye

*This write-up is based on the proceedings of a recent forum held for members of the Criticaleye community. Participants attended this event to hear a panel of experts discuss **sustainability in an increasingly regulated business world**. Following **four** short introductory speeches, the panellists were posed questions by the audience of Criticaleye members. Aside from the speakers, no names or companies have been noted to encourage open debate. To watch a video of this event, please sign into the Criticaleye website at <http://www.criticaleye.net> and click on Insights, TV.*

To instigate or to be part of future discussions in this area, to initiate a connection with other interested members or to request research from our affiliate and academic partners, please contact your Relationship Manager.

Introduction

Despite a down-turning global economy, a clear sustainability strategy remains crucial to success. In many industries, regulation designed to minimise the adverse effect of business activity on the environment and social well-being is already in place. For those without regulation, it is not a question of 'if', rather 'when' and 'to what degree' it is put in place and it will start to take effect.

Criticaleye Members attended this event to look at how organisations might prepare themselves for regulatory change. A panel of experts offered their thoughts on a variety of issues.

Speeches

Accenture's **Peter Lacy**, Head of Sustainability Practice, Europe, Africa and Latin America launched the discussion.

Peter outlined a number of important forces that are dramatically shaping the business context for global companies:

1. Natural resources pressures
2. Employee attitudes
3. Capital market interests
4. Consumers behaving as citizens
5. Stakeholder expectation
6. Policy and regulation

Unprecedented development over the past decade has led to competition for and scarcity of resources, particularly in energy and water. It has also led to a dramatic increase of greenhouse gases and carbon in the atmosphere. The UN believes that in order to settle emissions by 2030, a \$600 billion investment, per year, every year is needed.

Capital markets are increasingly interested in sustainability, not just as a prism to better understand their investments, but also in terms of growing markets and investing in alternative energy. Growing carbon markets are approaching \$150 billion by the end of this year and could rise to \$2-3 trillion if the US introduces a cap and trade system in the coming years.

Policy and Regulation

Globally we are moving toward a post-Kyoto framework and the UK and Europe have forums set up in the next year to discuss where policy will go. There is increasing certainty that an appetite for a global deal exists and to set up a global architecture. Indication of this is how much these positions were taken up in the US Presidential election with both candidates pushing for cap in trade – even if they disagreed about how emissions allocations will be auctioned.

In spite of global uncertainty, the EU has committed to reduce emissions by around 8 per cent between 1990 and 2012 and by 20 per cent 2020 and 30 per cent by 2030 - if other nations are prepared to do similarly. They have established the European Emission Trading Scheme, the most important economic mechanism for pricing and factoring carbon into the economy. This is a smart investment from a risk management perspective and a way to tap into a wave of innovation that is taking hold as we shift to a low carbon economy.

European Commission President José Manuel Barroso and his team believe that this will be an investment in jobs and growth with nearly a million new jobs by 2020. This European standpoint is trickling down to a national level, in the next four weeks we'll see the Climate Bill passed in the UK, which will bring into law carbon budgets and ongoing reductions and targets. This

cascades down through to the carbon reduction commitments of individual companies that will have to reduce emissions or buy credits on the carbon open markets, increasing the cost and price of doing business. We often hear that businesses are against this kind of framework, but many of the leading companies that Accenture works with and through our research with the World Economic Forum last year, we found that four out of five businesses want this clarity in policy so they might make longer-term investments as they move forward. What we see is enormous value at stake in this emerging regulatory environment.

Strategies companies are employing to create competitive advantage:

1. Revenue growth opportunities – new products, services, entering new markets and differentiation
2. Risk management – regulatory risk and operational risk over time
3. Building brand, reputation, networks and intangible assets
4. Reducing costs through energy and resource efficiency

How are they doing this? In four ways:

1. Going it alone where there is a clear competitive advantage and market, for example Toyota and the Prius or Phillips, that in the last five to six years has invested half a billion dollars in lighting technology and now has a portfolio of green products representing \$4-5 billion – or 15 per cent of their overall revenue. New players are also emerging like Vestas which was a small company a few years ago and is now a multi-billion dollar competitor in the wind turbine business.
2. Collaboration – working with research and academic institutes to access new ideas and tap into R&D and innovation; also collaborating with NGOs – particularly where there is an imperative to compete for trust.
3. Setting Regulation –those large players in a sector (where there is no realistic chance of regulation) are setting regulation themselves and working at industry level to set voluntary standards, for example, in the postal and logistic sector with IPC and in the mining sector with IISI.
4. Shaping regulation by actively working with policymakers and regulators. The Climate Action Partnership in the US, for example, is progressively lobbying for a US cap and trade system.

These are not mutually exclusive; the really smart companies are doing all four at once, GE for example, whilst at the same time is pushing for cap and trade is developing an innovative portfolio of products that is likely to benefit and accelerate the shift to that low-carbon economy.

Challenges and success

The biggest challenge is to shift from strategy to execution: Executives surveyed by Accenture see a performance gap in what they felt they *should*

be doing and what they were *actually* doing on the ground to prepare their companies to take advantage of sustainability.

Our research in high performance companies confirms this; paying real attention to the building blocks that underpin sustainability is crucial. High performing companies focus on the markets they play in, think carefully about how strategies are structured and how they approach marketing and R&D. They are looking at reengineering supply chains, examining IT's strategic use across the business, and the way performance is measured over time. And finally, the way in which they enable the organisation from a people and culture perspective; successful firms are looking at creating the right knowledge, skills and attitudes to make this a mainstream business issue.

What about sustainability in the economic downturn?

Be careful and realistic. Discretionary sustainability will slip off the agenda, and anything that isn't aligned with business objectives will disappear as times become more challenging. However, the fundamental drivers underpinning sustainability aren't really shifting that much.

There is still consumer demand; they may not be prepared or able to pay a differentiated price but this shouldn't be confused with consumers not differentiating. They will punish poor performers and reward good performers.

Furthermore, there has been no slowdown in the regulatory process. It's significant that in the same week that the UK government launched a \$500 billion bail-out of the banking system; it also created a climate change and energy department headed up by a Cabinet minister. Rather than taking the foot off the gas on climate targets, the UK Climate Committee decided to increase them from 60 to 80 per cent.

Additionally, as a result of the global economic crisis – there is more intervention from policymakers/regulators and attitude change towards risk on a societal level. While this may begin with the banking and financial sector – it's going to spill over into other areas, which on the one hand risk overcorrection in intervention. On the other hand, for climate change this could result in emboldened policy right across the board and a new imperative for companies to 'compete for trust'.

Accenture's research over time and looking at previous recessions has shown that high performers use the downturn to position themselves for growth and accelerated trajectory as the economy turns. For example, opportunities abound for smart M&A activity given plummeting valuations in areas such as alternative energy.

We may well look back in terms of this period as the point at which global companies either did or did not position themselves for competitive advantage as we shift to a low-carbon and sustainable economy.

The floor then turned to **Gareth Llewellyn**, Head of Safety & Sustainability, Anglo American, plc

One can do a lot of work in the space of sustainability, but unless it is tied into commercial activities, the work will mean absolutely nothing. Gareth explained that he would use his time to outline four companies that have

succeeded in tying sustainability with commercial rewards and track each back to changes in legislation.

How a good understanding of legislation can contribute to a sustainable business stream (Biffa)

Biffa, one of the largest waste management companies in the UK, had a core business of collecting rubbish for landfills, which brought in good return. As energy prices increased and regulatory bodies demanded that all biodegradable waste be diverted elsewhere, the Biffa team realised that not only was there methane emerging from its sites, but that there was a possibility this gas could be turned into energy. Biffa invested substantially into the area of energy recovery looking particularly at landfill sites and anaerobic digestives. It had 109 megawatts of renewable energy on its system and is now one of the largest suppliers of renewable energy to the UK market.

With the knowledge of the legislation, Biffa had two options; it could become an energy supplier, in which case, the way the market is constructed it would have to hedge its contracts because if it couldn't guarantee supply, it would have to find it elsewhere. Alternatively, if it applied for renewable obligation certificates on every one of those installations, it could earn a top up in addition to the energy price, and sell it to the other generators.

This company was sold to private equity in April (2008) and interestingly, they were very focused on power. This is why it sold at a 43 per cent premium to the share price in the previous three months. Just before the credit crunch.

This example shows that an understanding of the legislation can mean a new business model alongside existing work, which can generate much value for shareholders.

How confidence in dealing with the regulator leads to changes in incentives (National Grid)

National Grid was paid on the amount of electricity and gas it shifts, which isn't the best long-term business model to have in a carbon-constrained world. It hoped to create a different model for incentives, where it got paid more money for delivering less of its product. It negotiated for the length of its rate agreements – and some extended to 25 years – a series of incentives where if it invests in energy efficient equipment at its customers' premises, it will earn a rate of return on that equipment for the lifetime of its rate agreement. So the more money it puts into helping its customer use *less* of its product, the more money it earns over that rate agreement.

This example shows how creating a separate business model around understanding regulation and how one can negotiate with regulators.

This model hasn't developed in the UK, because there is a rule that says if a consumer does not like their supplier, they can go elsewhere after 28 days. Why would an energy supplier invest in a property's equipment?

How foresight in creating incentives in the absence of regulation can create opportunities (Anglo American)

One of the biggest risks to Anglo American's miners in South Africa is flooding in the mines. Ironically, at the surface, there is virtually no water for local communities. By partnering up with BHP Billiton, Anglo American built one of the largest water treatment plants in southern Africa east of Johannesburg. It pumps water out of its mines, and treats it. It negotiated incentives with the regulators to provide this water to local communities, and additionally strips the gypsum out to sell as a building product. As a side benefit, the miners are much safer now.

This shows how beneficial it can be to have the confidence to go to the regulators and say, 'we need something on the table that will give us the revenue stream over a period of time to do this properly.'

How SD-related legislation can be exploited to create reputation advantage (bio-fuels companies)

A largely unrecognised trading scheme was introduced in the UK to increase the amount of bio-fuels coming into this market through the four court suppliers. Interestingly, for the first time – it has carbon and sustainability criteria attached to it. The Renewable Fuels Agency reports monthly, quarterly and yearly on how sustainable the sources of bio-fuels that enter this country are.

This scheme is designed to increase the pressure on the likes of Shell and others to demonstrate that they are sourcing bio-fuels from the right areas and not putting overseas populations at risk. As a general trading scheme, it has companies competing to have more sustainable sources for reputation and commercial advantage.

These are my practical examples of how companies are now actually making money from sustainability legislation. The more leaders think about what they can do to benefit their companies commercially, the better it will be for the environment and surrounding communities.

Next up was **Richard Laing**, Chief Executive, CDC

Whatever's happening in the financial markets, there can be no more important subject for business people to be thinking about as the issue of sustainability. If we don't we won't be *in* business in the long term.

CDC is the UK's bilateral development finance institution, which is part of the UK's International Overseas Development Programme; it exists to beat poverty – which can only be defeated by the creation of wealth, and wealth in the long-term can only be produced by the private sector because it's the private sector that will pay the taxes that will employ people that will create the wealth.

CDC invests capital in private sector businesses in the world's poorest countries. It has a net worth of about \$5 billion which is put to work mainly through private equity funds and others that invest capital into these businesses. There are about 600 underlying business ranging from small SMEs right up to big infrastructure projects and down to micro finance. There

are 250,000 direct employees and many more indirectly and the micro finance leg probably touches about 2 million people. Increasingly, societies are demanding that businesses take sustainability more seriously and this is increasing in emerging markets.

Richard explained how over 20 years ago, he worked in Brazil for a company that paid the best wages in the market, supplied free meals to employees, provided healthcare, took health and safety seriously and made an effort not to pollute the local environment. Back then, 'sustainability' as we know it didn't exist, but retention was high, strikes, rare and absenteeism, low - because no one was injured from bad equipment. As an overseas business, this was the best approach.

Today, companies working in emerging markets are aware of this, but many local entrepreneurs are suspicious of sustainability. For these individuals sustainability can represent interference and increased cost, however there is an encouraging trend as they realise it's in their interest to take it more seriously.

Examples of companies in emerging markets benefiting from sustainability:

- Arch Pharmed is an Indian pharmaceutical company. In order to attract US customers it decided to become US FDA registered. In the CEO's words: "Bringing our production standards up to USFDA level adds 50% to our costs. However, this is still only 30 per cent of what it would cost Pfizer to produce in the EU or the US. We are getting new business as fast as we can acquire new production facilities and bring them up to top international standards."
- Deacons is a Kenyan retail business with good market share in women's clothing. It agreed to partner with a cancer awareness NGO and introduced breast screening in partnership with that NGO alongside some of its stores. The result is that it now has the dominant market share.
- Suntech is a Chinese solar panel manufacturer. It grew quickly and the owners, of which one of CDC's funds was one, wanted it to list on an international stock exchange to attract international investors. It knew that to do this it would have to upgrade its health and safety processes. It did and indeed, it listed in the US a couple of years ago.

The main message is that there is a real desire to embrace sustainability issues. However, that desire comes with a big "but", and that is there has to be some commercial upside.

The other main source is government. Companies operate in a business climate set by government. It is legislation and regulation that will drive behaviour in many of these countries, but it is not always strong.

Current economic climate

Richard explained that he has a number of concerns but also some considerable optimism for sustainability issues.

Cynical adherents of sustainability amongst businesses will shy away from commitments. There is a real risk that some or even many will use the current climate as an excuse to pull back. Japan, for example, has a good track record in many respects, particularly in energy efficiency programmes. But recently, a leading business association was decrying that the new environmental taxes were undesirable in the current economic conditions.

There is some evidence in CDC's markets that sustainability improvements are being put on hold whilst the economic background tightens.

These trends need to be resisted strongly. Those committed to sustainability need to proclaim the message as strongly as ever and demonstrate through our own companies' behaviour that commitment levels are not being reduced just because of the current economic climate. Pulling back will back fire as companies will simply be viewed as not having been genuine in the first place.

Optimism

Businesses' momentum in the sustainability arena has shown commitment to progress in long-term. If capitalism is to remain the basic framework for the world's economies, more regulation will be required, certainly around banks. The unrestrained capitalism let loose under Thatcher and Reagan will not be accepted. Can we in some way harness that appetite for more control to push through better and tougher regulation on sustainability issues? We need to ensure that businesses are provided with both carrot and stick to implement better sustainability practices. Like so many issues today, this will require international cooperation. However, with political will, there could be a one-off opportunity to grab the mood of the moment to push forward in this area.

Attention then fell on **Christine Farnish**, Public Policy and Sustainability Director, Barclays Bank

Sustainability tended, until recently, to be defined narrowly and largely in environmental terms. For many stakeholders the concept of sustainability is now much broader and encompasses frameworks and business models. Sustainability needs to be embedded in a business if leaders want to lay claim to it and it will vary from business to business. Sustainability for Barclays, for example, will be different from other companies, because it will be rooted in our business strategy and what's important to us.

Impacting Forces

Regulation will play a role in sustainability going forward. But to a degree, companies' response to sustainability is driven by the need to manage their corporate reputation.

Christine explained that individual companies can benefit from aligning with other firms in the same sector to self-regulate. An example of this is the way

Barclays has helped lead the sector to develop the Equator Principles, a set of environmental and social standards applied to major project finance.

Another strategy the bank has adopted is to work very closely with opinion leaders and policymakers to help shape frameworks that allow companies to be 'good', without commercial penalties.

Barclays' focus in these areas is rooted in the fact that it is a major bank and therefore a key part of the economic and financial system. For Barclays, economic sustainability is probably more important, in terms of the contribution we can make to the broad sustainability agenda, than environment or social issues. Barclays has therefore chosen to prioritise two major strands of work:

- Fair treatment of customers and clients – offering products THAT are transparent and fair and providing good customer service if things go wrong
- Inclusiveness - being an inclusive bank by developing products to meet the needs of all sections of the population where this is commercially viable; this is an exciting opportunity in emerging markets where access to the financial system can lift communities out of poverty

Credit crunch

Unsustainable business models are now facing significant challenge. To this point, the public policy response has focused on regulation that is more intrusive in an effort to prevent similar crises in the future. It will be important that policymakers and regulators don't knee jerk to overregulation that can put up costs to consumers reducing choice and innovation. We need to get the balance right. If banks become a utility, then one thing can be guaranteed: the consumer will probably get a worse deal, especially over time. One good feature to emerge from the current debate is that most people now recognise that global regulatory frameworks need to be strengthened and improved, and that the economic system can't be dealt with on only a nation state level. International frameworks need to be modernised; if this can be done for economic and financial services sectors, then it should be easy to stretch across to climate change and other difficult, long-term sustainability challenges.

Question and Answer Session

How do we 'do the right thing' rather than simply complying and doing things right?

Gareth: Companies need to give reassurance to people that they are *actually* doing the right thing – because issues tend to get hidden. Giving a framework that lays out 'what we think, as a business' is the right thing and how it's going to produce return is absolutely critical.

Peter: This is a leadership issue. Leaders today struggle with timeframes set out by many different stakeholders, such as investors concerned with quarterly deliveries or policymakers interested in the next electoral cycle. The

tone needs to be set from the top – that these social, ethical and environmental issues are important throughout the organisation.

Richard: ‘Doing the right thing’ is a value-based statement that could mean many things to many people. However, the basis has got to ask what society wants. Unless there is an incentive for a business to do something, the management of that business will not do it – and that’s why I don’t think you can de-link it from compliance.

Christine: Compliance is a last resort in many ways as there is commonly a lag between what standards of good practice are generally expected by opinion leaders and the regulatory response. At the moment, we could see this pendulum swing toward a very intrusive regulatory era because regulators and politicians are under intense pressure.

Will we see a U-turn on how sustainability issues are audited and reported?

Peter: It is quite feasible that we will see a spill over of intervention from the financial markets into other business arenas and this could play into ways of reporting. Societal attitudes towards risk are changing – and this includes financial and non-financial risk. With regard to reporting and the OFR, looking carefully, there are some sleeping giants and it depends how that is interpreted that and how companies are scrutinised by regulators – there is plenty of meat for investors to sink their teeth into.

Gareth: My view of reporting is slightly archaic because many companies put a huge amount of information into the public domain which they will never use to manage their business. The extra burden of doing that doesn’t improve the way businesses are run, it means it’s probably gone too far. People want to know that businesses are being run properly and not just passing on information for the sake of it.

Christine: Companies are today under continual pressure to be more accountable and transparent about their practices, challenges and the judgements they make on difficult public interest issues. I’m not sure that formal, compliance-driven reporting efforts always help much in this respect unless the matters at hand are capable of objective and quantifiable reporting.

Is regulation seen as opportunity for governments/regulators to make money?

Christine: When regulation is set into primary or secondary legislation it’s hard to go back and revisit. We need to think and help government regulate better, build opportunities for review every two to three years to check on regulation and get it right.

Richard: Can regulation lead to inefficiencies? Yes, it can but that doesn’t mean we shouldn’t have regulation, as it’s necessary to make progress. All regulation needs to be well thought through with proper feedback loops enabled.

Gareth: Surviving companies have woven their way through legislative issues and created models that actually don’t rely on the legalisation. We

tend to focus on the downside of legislation rather than encouraging companies to do the right thing even if that legislation isn't there or badly worded.

Peter: Those that differentiate are those that shift very quickly from understanding the regulating environment to working with regulators to come up with win-win, ie, good sustainability impact/good commercial opportunities, and they do this very quickly. An example of this is with National Grid, that created a great new customer value proposition. Understand it, move ahead of the curve and translate it quickly to action.

How does a company create a global sustainable development strategy that works locally?

Christine: Our strategy has not so much been for sustainable development as it has been a strategy for sustainable *business*. We have five broad strands (customer centricity, inclusiveness, respecting diversity, managing environmental impact, and being a responsible global citizen) which each business unit interprets and progresses in line with its own business planning processes. They then have to report back to an executive committee and are held publicly accountable once a year when we publish our progress on our five themes.

Gareth: In the late 1990s, National Grid established a framework to delineate how to run the organisation to 'do the right thing' and it had three elements: sustainable growth, profits with responsibility and investing for the future. Under all three was the underlying agreement that we would accept lower levels of profits to 'do the right thing,' increasing, for example, the safety professionals on site when we downsized in the US to avoid worker injury.

Peter: Sustainability needs to be on the CFO's agenda – he or she should understand the value this delivers to the business. The other level is genuinely integrating it into performance contracts for managers, ie, looking at how to reward and incentivise behaviours.

How sustainable is sustainability itself?

Richard: Businesses have lost sight of what the core issues are – which used to be environment, social issues and governance. It has now become about looking after customers and other things. It has become very general – it's a trend we need to check very carefully. 'Doing the right thing' is something we need to be wary of – because it's far too broad and needs to be put into a much better intellectual framework.

Gareth: Dr Gro Harlem Brundtland, the former Norwegian Prime Minister and now director general of the World Health Organisation said sustainability is meeting the needs of today without compromising the ability of future generations of meeting their needs. Businesses face many issues that could be called sustainability, but nothing matters unless they are addressed properly.

Peter: We saw the birth of *e-commerce* about ten years ago – but who uses this term any longer? It just means that business has been enabled and empowered by technology. My hope is that sustainability does disappear as

a concept and becomes embedded in the way in which we structure our business models and our strategy. If and when this happens, I'm sure we'll find a new word to replace it.

With that, the Forum came to a close. The panellists were thanked for their involvement.

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